Agenda Item No:

Report to: Audit Committee

Date of Meeting: 17 September 2015

Report Title: **Treasury Management - Mid Year Report 2015-16**

Report By: Peter Grace
Assistant Director – Financial Services and Revenues

Purpose of Report

This report advises the Audit Committee of the Treasury Management activities and performance during the current year. It provides the opportunity to review the Treasury Management Strategy and make appropriate recommendations to Council to take account of any issues or concerns that have arisen since approving it in February 2015.

Recommendation(s)

1. **Cabinet recommend to Council that the Strategy remains unaltered.**
2. **To accept the report and note that the investments made are in compliance with the investment strategy and the latest advice provided from the Council's Treasury Management advisers.**

Reasons for Recommendations

The Code of Practice on Treasury Management requires, as a minimum, a mid-year review of Treasury Management Strategy and performance. This is intended to highlight any areas of concern that have arisen since the original strategy was approved (February 2015). It is a requirement of the Code of Practice that the Mid-year review is considered by Cabinet and full Council.

Introduction

1. The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties.

2. The other main part of the treasury management service is the funding of the Council's capital plans. Whilst parts of the Capital programme are financed by grants, contributions or capital receipts, the unfinanced elements will determine the borrowing needs of the Council - essentially the longer term cash flow planning to ensure the Council can fund its capital spending. The management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

3. Accordingly treasury management is defined as:

   "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

4. The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) has been adopted by this Council and this Council fully complies with its requirements.

5. The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the Full Council of an annual Treasury Management Strategy Statement (including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead), a Mid-year Review Report (as a minimum) and an Annual Report covering activities during the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body which in this Council is the Audit Committee.

6. The purpose of this report is to meet one of the above requirements of the CIPFA Code, namely the Mid -Year review of treasury management activities, for the financial year 2015/16.

7. This mid-year report covers

   a) An economic update for the first nine months of 2015/16;
   b) The Council's treasury position
   c) A review of the Council's borrowing strategy in 2015/16
   d) A review of the Council's investment strategy in 2015/16
   e) A review of compliance with treasury management prudential indicator limits for 2015/16

8. The Committee will need to determine whether there are any issues that they wish to draw to the attention of Cabinet or Council.

Economic Update

9. Economists suggest that the UK economy could be facing another short period of deflation on the back of oil prices slipping back below the $50 per barrel level and sterling continuing to gain in value. That combination will maintain downside inflationary pressures on both food and consumer goods prices. That said, the Bank of England will see these as temporary, externally driven influences and should look through them and monitor the internal inflation levels, which themselves are currently quite subdued.

10. Wage growth has improved but employment has stalled, indicating that improved productivity is underpinning economic recovery. With limited inflationary pressures this scenario, taken on a standalone basis, would not be a cause for the BoE to rush to raise interest rates. US economic activity remained sufficiently solid to point to a bounce in growth in Q2, despite data being more mixed after a healthy performance in May.

11. Retail sales declined in June but consumption growth over the quarter will support the economy, while non-mining, commercial building investment has surged. Analysts were looking for 2.8% annualised growth for the quarter but there may be upside potential.

12. The Eurozone, meanwhile, has not been overly affected by the Greek debt crisis and the greater concern is likely to be the slowing in the labour market recovery.

13. Unemployment rose for the first time in nine months in June and employment intentions have also softened, adding to the questions about the strength of the economy and whether current levels are sustainable. The initial Q2 GDP growth estimate of 0.7% q/q confirmed that the economic recovery picked up, with services and industrial sectors having a positive quarter, though construction output was flat.

14. June retail sales were weaker but do not indicate a problem. Consumer confidence remains strong. The housing market recovery appears to be back on track, with the Nationwide price measure rising in July and mortgage approvals picking up from a

weak May, helped by a lowering in the average two year fixed mortgage rate.

15. The trade deficit declined to £0.4bn in May because of a sharp decline in volumes of imported goods, while export levels were a touch firmer as sales in non-EU countries expanded strongly. Exporters have, though, cut sterling prices to compensate for sterling gains, with prices down 3.1% y/y in May, but this has not prevented movement in foreign currency prices.

16. Unemployment rose, unexpectedly, with the unemployment rate rising to 5.6%, as employment fell by 67,000 in the three months to May. This is not a serious reversal and annual employment growth is still running at a healthy 0.9%, while employment intentions indicate that robust job growth remains the case. Job vacancies are still close to the recent highs. Wages have been given a lift as labour market slack declines. Average weekly earnings growth improved to 3.2% in May, far in excess of inflation rates.

17. Meanwhile, productivity growth has improved. Analysts expect the UK economy to experience another bout of temporary deflation in the months ahead after CPI slipped to zero in June, largely on a drop in clothing inflation, as summer sales started early this year. Oil prices have fallen, so both diesel and petrol prices have further downside potential, particularly as the latter have not yet reflected the drop in oil price. Fuel could, thus, remain a negative weight on CPI inflation for some time yet. Energy's contribution could pull CPI lower if utility suppliers follow British Gas' lead in cutting prices. In addition, the downturn in Chinese growth has the potential to further depress commodity prices but these will take time to feed through into CPI figures.

18. The strength of sterling, up 6% since the start of the year, will keep a lid on consumer goods import prices, and in the meantime push them lower. As noted, deflation should prove short lived as rising agricultural commodity prices will see food deflation declining as the year runs down, while services inflation will be pushed higher as wage gains impact. This should partly offset the softness in goods inflation, which looks likely to persist.

19. Widespread deflation is not a risk of becoming a widespread or ingrained problem, and household medium term inflation expectations have generally held up, while a number of measures of domestically generated inflation have pushed higher in recent months. Overall, then, economists do not see inflation moving too far from the zero level for the remainder of the year, before gradually increasing back to the 2% target in a couple of years' time.

20. The markets are still looking for the first UK rate rise around June 2016, but there are signals that the MPC is set to become split on the timing of the course of interest rate rises at coming meetings, given more hawkish comments from some members.

21. **Interest rate forecasts**

	NOW	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
BANK RATE	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.50	1.50	1.75	1.75
3 month LIBID	0.46	0.50	0.60	0.70	0.80	0.90	1.10	1.30	1.40	1.50	1.80	1.90	1.90
6 month LIBID	0.63	0.70	0.80	0.90	1.00	1.10	1.30	1.50	1.60	1.70	2.00	2.10	2.10
12 month LIBID	0.94	1.00	1.10	1.20	1.30	1.40	1.60	1.80	1.90	2.00	2.30	2.40	2.40
5 yr PWLB	2.19	2.30	2.40	2.50	2.60	2.80	2.90	3.00	3.10	3.20	3.30	3.40	3.50
10 yr PWLB	2.77	2.90	3.00	3.20	3.30	3.40	3.50	3.70	3.80	3.90	4.00	4.10	4.20
25 yr PWLB	3.31	3.40	3.60	3.80	3.90	4.00	4.10	4.20	4.30	4.40	4.50	4.60	4.60
50 yr PWLB	3.17	3.40	3.60	3.80	3.90	4.00	4.10	4.20	4.30	4.40	4.50	4.60	4.60

(The Capita Assets Services forecasts above are for PWLB certainty rates.)

The Council's Treasury Position – 31 August 2015

Borrowing

22. The Council's debt and investment position at the 31 August was as follows:

Table 1 **Debt**	30 December 2014 Principal	Rate	Maturity	31 August 2015 Principal	Rate
PWLB Loan 1	£7.5m	4.80%	2033	£7.5m	4.80%
PWLB Loan 2	£1.0m	2.02%	2016	£1.0m	2.02%
PWLB Loan 3	£1.0m	1.63%	2018	£1.0m	1.63%
PWLB Loan 4	£2.0m	0.56% (Variable Rate)	2019	£2.0m	0.61% (Variable Rate)
PWLB Loan 5	£0.9m	3.78%	2044	£0.9m	3.78%
PWLB Loan 6	£1.8m	3.78%	2044	£1.8m	3.78%
Total Debt	£14.2m	3.59%		£14.2m	3.59%

23. At the 31 August 2015 the Council had debt amounting to £14.2m (all PWLB debt).

Investments in 2015-16

24. In terms of investments the Council had £28.3m invested in August 2015 with a variety of institutions (this level varies on a daily basis throughout the year).

25. The table below provides a snapshot of where the investments and deposits were placed on one day in August 2015.

Counterparty	Rate/ Return (%)	Start Date	End Date	Principal	Term
Barclays	0.6500	Call Account		£2,805,711	Call Account
Nordea Bank	0.5600	01/04/2015	01/10/2015	£5,000,000	Fixed (CD)
Commonwealth Bank of Australia	0.3000	17/08/2015	19/08/2015	£1,000,000	
Standard chartered	0.6700	01/04/2015	01/10/2015	£5,000,000	Fixed (CD)
Lloyds	1.0000	10/04/2015	08/04/2016	£5,000,000	Fixed
National Westminster Bank	0.6000	Call Account		£5,000,021	Call 60
Coventry Building Society	0.6000	14/05/2015	16/11/2015	£2,500,000	
Lloyds LAMS	4.4500	05/01/2012	10/01/2017	£1,000,000	Fixed
Lloyds LAMS	1.9700	26/03/2013	23/03/2018	£1,000,000	Fixed
National Westminster Bank	0.5000	Call Account		£2,509	Call Account
			Total	£28,308,241	

26. The performance for the first 5 months of 2015/16 provided an average return of 0.88 % including the Local Authority Mortgage Scheme (LAMS) and 0.68% excluding LAMS.

27. The total interest receivable for the first 5 months is £93,000 including the Local Authority Mortgage Scheme and £66,000 excluding LAMS.

Borrowing Strategy

28. The Council has £14.2m of PWLB debt, and could potentially borrow up to a level of £18.5m. This figure does not take account of capital spending in 2015/16 which could potentially be funded by new borrowing.

29. The 2015/16 budget included the costs of borrowing £1,925,000. The large schemes in the Capital programme being the construction of a new industrial unit (BD Foods - £700,000) and for a further grant to Amicus Horizon (Phase 2 of the Coastal Space project - £875,000).

30. Whilst the borrowing rates are attractive on a historical basis the difference between the return on investment and the cost of borrowing is significant – the revenue cost falling on the Council taxpayer. There is a case for taking new borrowing before rates increase again and a balanced view will be taken.

31. The Council also keeps under review the potential for making premature debt repayments in order to reduce borrowing costs as well as reducing counterparty risk by reducing investment balances. However, the cost of the early repayment premiums that would be incurred and the increase in risk exposure to significantly higher interest rates for new borrowing, continue to make this option unattractive. The early repayment cost of the £7.5m PWLB loan, maturing in 2033, would amount to some £2.9m. No debt rescheduling is being contemplated at present

Investment Strategy

32. Priority is given to security and liquidity of investments in order to reduce counterparty risk to the maximum possible extent.

33. The Council has a limit of £5m with any one institution (rated A or above, supported by Government, and given a blue (12month) rating by Capita Asset Services). This generally represents a level of up to 25% of the investment portfolio with any one institution or group at any one time. It is also necessary, at times, to invest sums of this size in order to attract the larger institutions which have the higher credit ratings.

34. The Eurozone problems have led to a number of downgrades to banks' credit ratings, making it increasingly difficult to spread investments across a number of institutions. The Chief Finance Officer has the authority to amend the limits to ensure that monies can be placed with appropriate institutions.

35. The net cost to the Council of borrowing less investment interest and fees will be reviewed as part of the budget setting process. Differences will arise resulting from the timing and loan values in respect of the Amicus Horizon Coastal Space Regeneration project and the factory build..

36. The net interest on the deposits in respect of the LAM scheme for the year will amount to some £27,700 and will be transferred into the mortgage reserve in order to meet potential defaults (none at present).

37. The option for diversification of some of the investments into a property fund will be explored shortly, given the higher returns being achieved in some parts of the Country. Before any recommendations are put before Council, the Audit Committee and Cabinet will need to consider the risk implications. Until such time

Compliance with Treasury Limits

38. During the financial year to date there have been a few occasions where it has not been possible to find institutions to take the Council's money given the strict criteria in place. In these circumstances the Council will place money in its existing call accounts and this can thus result in the investments exceeding general limits. Where such an occasion looks likely to arise the approval of Chief Finance officer is required in compliance with the Council's Treasury Management Practices. The Prudential Indicators have been complied with - reproduced in Appendix 1 for reference.

Financial Implications

39. The Council's 2015/16 budget estimated a 0.7% return on investments. Based on current market conditions this is difficult to achieve given the lower interest rates currently available. However savings from the timing of new borrowing should help to ensure overall budget projections are achieved.

Risk Management

40. The Council spreads its risk on investments by limiting the amount of monies with any one institution or group and limiting the timeframe of the exposure. In determining the level of the investment and period the Council considers formal credit ratings (Fitch) along with its own advisers (Capita Asset Services) ratings advice.

41. The security of the principal sum remains of paramount importance to the Council.

Wards Affected

Ashdown, Baird, Braybrooke, Castle, Central St. Leonards, Conquest, Gensing, Hollington, Maze Hill, Old Hastings, Ore, Silverhill, St. Helens, Tressell, West St. Leonards, Wishing Tree

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Area(s) Affected

Central Hastings, East Hastings, North St. Leonards, South St. Leonards

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Policy Implications

Please identify if this report contains any implications for the following:

Equalities and Community Cohesiveness	No
Crime and Fear of Crime (Section 17)	No
Risk Management	Yes
Environmental Issues	No
Economic/Financial Implications	Yes
Human Rights Act	No
Organisational Consequences	No
Local People's Views	No
Anti-Poverty	No

Officer to Contact

pgrace@hastings.gov.uk
Assistant Director – Financial Services and Revenues
01424 451503

APPENDIX 1

PRUDENTIAL INDICATOR	2014/15	2015/16	2016/17	2017/18	2018/19
(2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS	£'000	£'000	£'000	£'000	£'000
Authorised Limit for external debt -					
borrowing	£20,000	£20,000	£20,000	£20,000	£20,000
other long term liabilities	£10,000	£10,000	£10,000	£10,000	£10,000
TOTAL	£30,000	£30,000	£30,000	£30,000	£30,000
Operational Boundary for external debt -					
borrowing	£20,000	£20,000	£20,000	£20,000	£20,000
other long term liabilities	£10,000	£10,000	£10,000	£10,000	£10,000
TOTAL	£30,000	£30,000	£30,000	£30,000	£30,000
Upper limit for fixed interest rate exposure Net principal re fixed rate borrowing / investments OR:-	100 %	100 %	100 %	100 %	100 %
Upper limit for variable rate exposure Net principal re variable rate borrowing / investments OR:-	100 %	100 %	100 %	100 %	100 %
Upper limit for total principal sums invested for over 364 days – LAMS Scheme and Coastal Space	£5,620	£5,620	£6,000	£6,000	£6,000

Maturity structure of fixed rate borrowing during 2015/16	upper limit	lower limit
under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%